

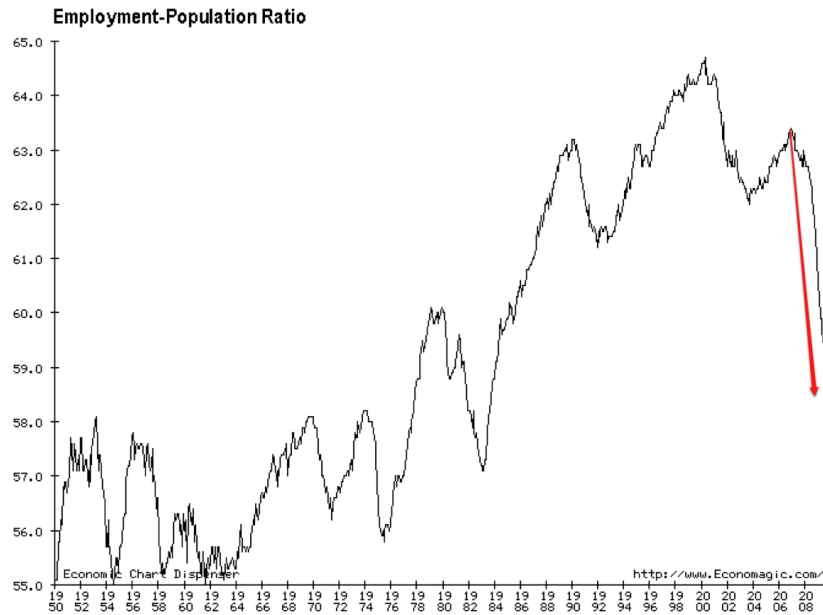
Reed College Public Policy Lecture

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The Employment-to-Population Ratio Is in Free Fall



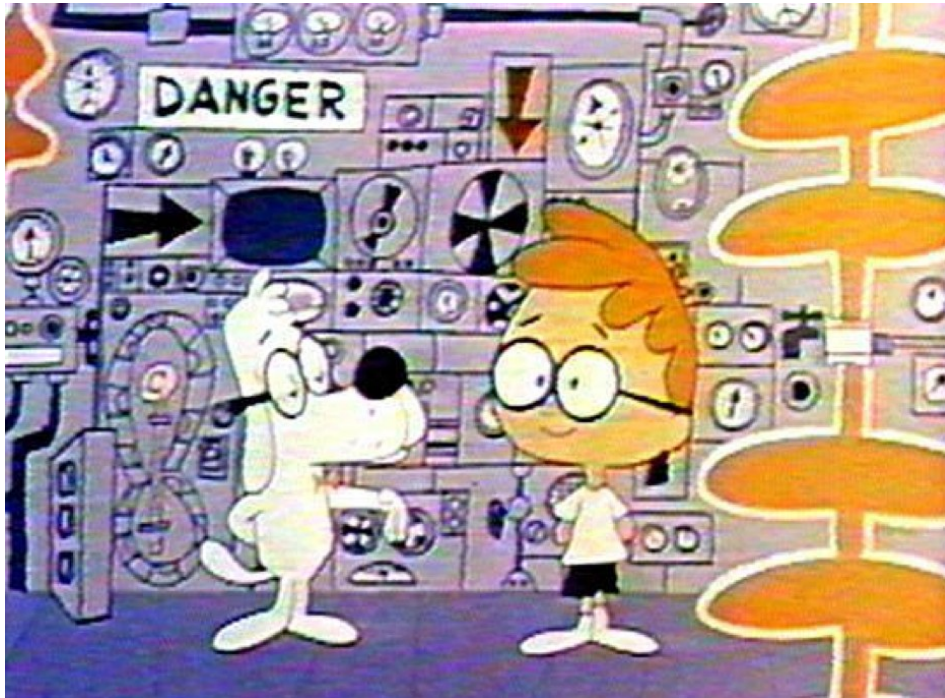
Twelve People I Want You to Meet

- Narayana Kocherlakota, Chicago economist
- Marianne and Henry Thornton, a letter-writer of the 1820s and her young banker brother
- Charlie Kindleberger, my teacher in the 1980s, MIT economist, student of manias, panics and crashes
- Irving Fisher and John Hicks, Great Depression-era economists
- Alan Greenspan, central banker of today
- Robert Rubin, banker of today
- Ben Bernanke, central banker of today
- Henry Paulson, Treasury Secretary of last year
- Christy Romer, chair this year of the President's Council of Economic Advisors
- Barack Obama, president this year

Narayana Kocherlakota

- Newly installed as President of the Federal Reserve Bank of Minneapolis
- Research in DSGE models.
- Three types of shocks:
 - A Great Forgetting
 - A Great Vacation
 - A Great Rusting
- None of these are plausible
- DSGE models useful for understanding comovements—why and how certain things move together in a business cycle
- DSGE models not so useful in figuring out:
 - Why now?
 - How big?
 - Or what to do?
- Resort to the WABAC machine instead...

The WABAC Machine...



Marianne and Henry Thornton



- Not Marianne Thornton: Ada, Countess of Lovelace, daughter of George “Mad, Bad, and Dangerous to Know” Gordon, Lord Byron
- Battersea Rise
- Pole, Thornton, and Company
- £40,000/5 = £8,000/year
- Think \$80 million a year today...
- Capital value of \$1.6 billion today...
- Choosing the right parents...

Pole, Thornton, and the Panic of 1825

- Irrational exuberance
- Excessive leverage
- Trust in liquidity
- Withdrawal of nine months' earnings with not five minutes' notice
- "Free... insisted on proclaiming themselves bankrupts at once, and raved and self-accused himself..."
- "Old Scott cried like a child of five years old, but could suggest nothing..."
- "Pole and Down were both out of town..."
- "Henry saw it all lay upon him..."
 - Looking for money in central London at 4:30 PM on Saturday afternoon
 - Let's ask the Bank of England
- "the failure of this House [of Pole, Thornton] would occasion so much ruin that he should really regard it as a national misfortune..."

Robert Banks Jenkinson



- Had been warning about “bubbles” for quite a while...
- Believed that allowing the financial system to crash would have very bad consequences for employment in manufacturing...
- For the first time, see, you had a large manufacturing sector—people who could not just go back to the farm if their employers could not borrow...

Did It Work?

QuickTime® and a
decompressor
are needed to see this picture.

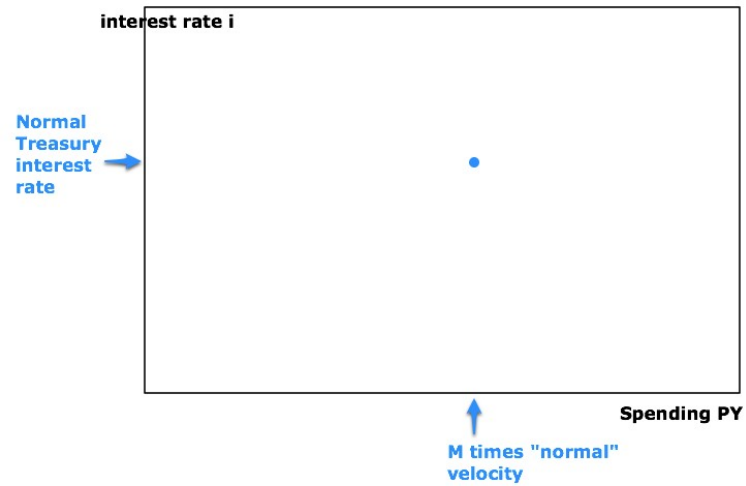
Charlie Kindleberger

- The Minsky cycle:
 - Displacement
 - Enthusiasm
 - Profits
 - Optimism
 - Runup
 - Greater fools around the corner
 - Uneasiness
 - Panic
 - Revulsion
 - Discredit
- Why do we care? Why not go read about Brad and Angelina, or watch “I Survived a Japanese Game Show”?
- The peculiar place of finance in a market economy
- We believe in market prices—but not when the prices set by markets are a series of semaphore flags telling businesses to shut down and create mass

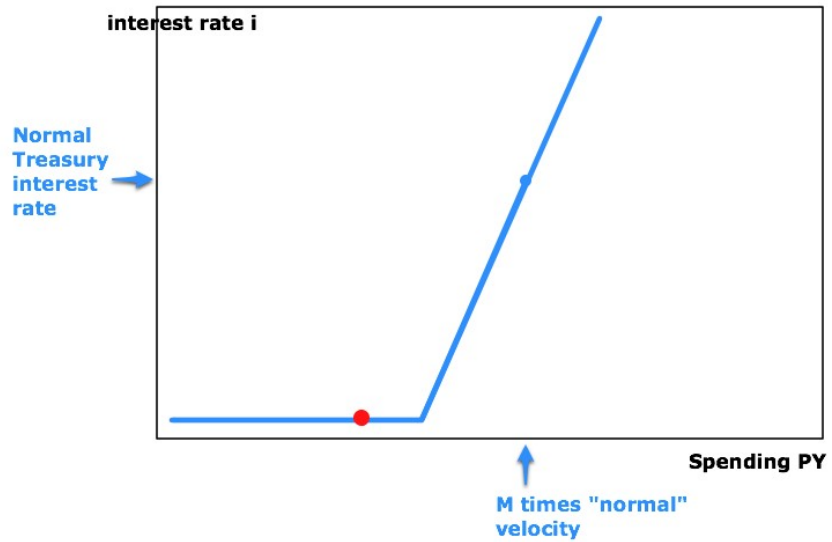
unemployment.

Irving Fisher and John Hicks

The Quantity Theory of Money



The Liquidity Trap



Alan Greenspan

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- Did not worry about liquidity traps
- Believed that he could deal with any financial crisis
- Had a substantial amount of evidence on his side
 - 1987
 - 1991
 - 1998
 - 2000
- Now a relatively unhappy man

Robert Rubin

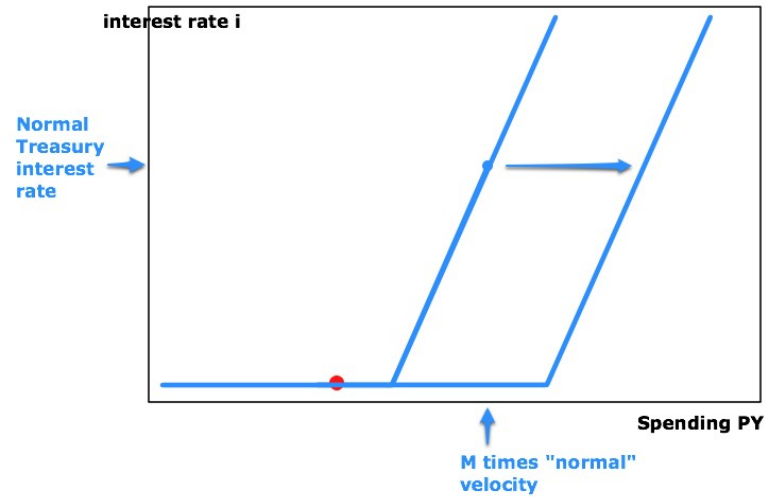
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- Risk management
- “Liquidity puts”
- “[Y]ou might think the existence of the put would make it impossible for Citi to get those CDOs entirely off its balance sheet. But in fact Citi found a complex accounting rationale for doing exactly that...”
- The problem of compensation structures
- Every 35 year old a risk manager

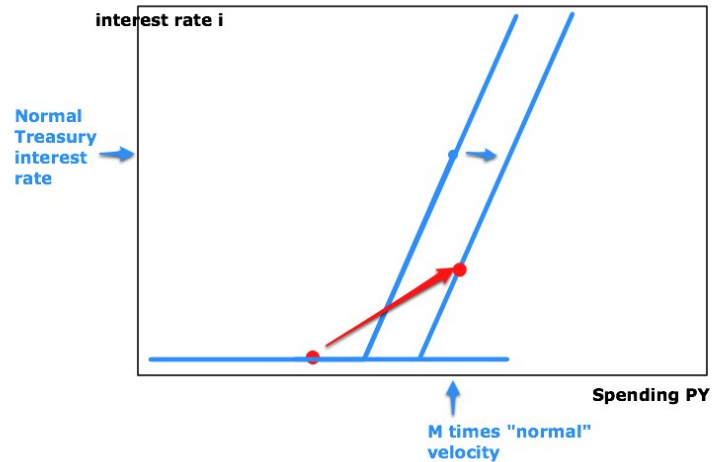
Ben Bernanke, Henry Paulson, Christy Romer, and Barack Obama

- What should they have done?
- What have they done?
- What are they doing?
- How will it work?

In Normal Times: Expand the Money Supply and so Boost Spending



Today: Expand Money Supply *and* Get Treasury Interest Rates Up to Less Abnormal Levels



But How Do You Boost Treasury Interest Rates to Get Spending Back to Normal?

- Supply and demand—make a parrot into a political economist
- Expand supply of Treasury securities
 - Make a lot more of them
 - Deficit spending—pull forward in time expenditures from the next ten or fifteen years.
 - Note that raising the national debt isn't a defect; it's the point of the policy
 - Financial alchemy via loan guarantees
- Reduce demand for Treasury securities
 - Treasury bond prices are so high now—and interest rates on Treasuries so low—because other assets are so unattractive.
 - Make other assets more attractive and demand for Treasuries will fall and T-bill interest rates will rise
 - Recapitalize the banking system
 - Make stocks more attractive as an inflation hedge by removing expectations of possible deflation

- Direct purchases—PPIP, etc.

Is the Government Doing Enough?

- Are we going to have another Great Depression? Almost surely no.
- Are we going to have a “lost decade” of economic stagnation like Japan in the 1990s? Almost surely no.
- Is the unemployment rate going to come down from its 10% now to 8.5% at the end of next year to 6% by the end of 2011? Almost surely no.
- Why not?
 - A worse shock than we thought we were getting a year ago—an 11-12% shock rather than the 9-10% shock we thought we were getting...
 - Policies that have been cautious:
 - \$1.2T vs. \$600B in extra deficit spending
 - Paulson desire to avoid temporary nationalization
 - This limits how much support for banking system—without nationalization the bankers gamble with (and profit from) public money
 - Moral hazard
 - Political viability

- A history that is not reassuring: jobless recoveries
- A history that is not reassuring: Vs and Ls

Vs and Ls

